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Bespoke Russia-CIS Consulting

Association of European Businesses
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Russia Macro Outlook

2015–2017

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Conclusions

- The benchmark interest rate is unlikely to be further cut until either the end April or mid June policy meeting. This is because inflation may not peak until early 2nd Qtr.
- The ruble will continue to be driven on the downside with weaker oil – but an oil price rally will not have the same direct impact as investors continue to worry about sanctions and low growth.
- Despite recent bounce, the price of oil is still more likely to text the 2009 low of $42 p/bbl (Brent).
- The government is in “survival mode” only and will remain so focused until it believes all parameters and risks are understood and may be planned for.
- The response since the start of this year has been better than the chaos of late last year. There is no risk of a credit or default risk in 2015 or 2016 and a potential bank sector crisis has been averted.
- The sectors most exposed in the current downturn are consumer (general), construction and banks.
- Import substitution/self-reliance is the new mantra in government – investment and business opportunities will open in sectors considered to be part of that strategy.
- Political relations with the “west” will remain bad for years past the crisis. But that will not mean that business and investment opportunities will be any more difficult for western companies.
- The pivot east is, & will remain, limited in scope. It cannot be a replacement for western investment.

Summary

- A contraction in GDP is now a given for 2015. The likelihood is that most macro indicators will worsen through the 1Q, and possibly, 2Q. The hope for a recovery starting in the autumn, and leading to modest growth in 2016, depends on:
    - Where the price of oil trades and the "net" impact on the budget
    - Sanctions – no material expansion and, specifically, if the block on accessing Western debt markets is eased
    - Ukraine – the military and political situation remains highly volatile and very dangerous
    - Whether we get an effective policy response from the government, especially in ruble management and in the banking sector
    - Whether this crisis drags forward and leads to several years of stagnation, with (then) growing risks for social instability, political changes, tighter regulations and a greater state role in the economy
    - Or, maybe this is the crisis which finally shakes the complacency and kick starts a more serious reform effort?
- The Ukraine/Sanctions/Oil crisis has added to the **problems already evident in the economy from early 2013**.
- The ruble will continue to be allowed to float freely against the oil price. For now the government remains committed to a full free-float and avoiding capital controls. But the emerging "global currency wars" and the ratings downgrade may force, or provide the excuse, to change that.

How bad in 2015?

- There is a wide range of growth forecasts for 2015 & 2016. Some of the extreme forecasts on both sides are more politically biased than economically defensible.

- The list of key variables includes:
  - *Politics and Sanctions – scope and duration*
  - *How long the current squeeze on the domestic liquidity markets lasts*
  - *Where the oil price trades*
  - *Where the ruble exchange rate trades*
  - *Inflation and interest rates*
  - *Government budget and policy actions, i.e. in response to the oil price + ruble rate combination*

- Some areas of the **economy will benefit from import substitution and the weak ruble** – these add some modest compensation to weaknesses elsewhere and are preventing a bigger collapse.

- By far the greatest strains to the economy are coming from lower oil revenues, the consequences of the volatile ruble, the lock-out of Russia from all Western capital and credit and the vey poor government/CBR response seen so far.

- The greatest threat to the economy in 2015 and 2016 is if there is a major banking crisis – it is possible but still perfectly avoidable.

Forecasts: base case

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- Indicators will be much worse in the spring than are expected for the full year (see *below*). Inflation is expected to reach 15% - 16% by spring. GDP is expected to contract by 5% or 6% during the first half. Investment spending & retail are expected to be much worse in 1H15.

- Base case is that EU & US start to ease some financial market sanctions from August 1st but keeps the block on accessing long-term credits in place. Oil dips to $40 p/bbl (approx) but rallies in the autumn

  - *IMF expects -3% for 2015 and -1% for 2016.*
  - *World Bank expects -2.9% for 2015 and +0.1% for 2016*
  - *EBRD expects -4.8% for 2015 (EBRD is always the most pessimistic concerning Russia)*

Russia: Macro Trends - Base Case

	2011	2012	2013	2014E	2015E	2016E	2017E
Growth, real % YoY	4.3%	3.4%	1.3%	0.5%	-4.0%	0.0%	1.5%
CPI - year-end, % YoY	6.1%	6.6%	6.5%	11.4%	12.0%	8.0%	6.0%
Gross fixed investment, real % Y	10.2%	6.0%	-0.3%	-3.5%	-10.0%	-2.0%	2.5%
Central Bank Key Rate, %				17.0%	12.5%	8.5%	7.0%
Retail sales, % YoY	7.2%	5.9%	3.9%	2.0%	-6.0%	0.0%	2.0%
Unemployment, % EOP	6.6%	5.7%	5.6%	5.3%	6.5%	6.0%	5.5%
Budget, balance % of GDP	0.8%	0.0%	-0.5%	-0.5%	-2.0%	-1.5%	-1.0%
Current account, % GDP	5.1%	3.7%	1.6%	3.0%	2.5%	1.8%	2.0%
RUB/US$, year-end	31.4	30.8	32.9	63.1	70.0	55.0	50.0
RUB/EUR, year-end	41.5	40.3	45.3	72.0	77.0	60.0	55.0
Urals, US$ p/bbl, average	$109	$110	$108	$100	$50	$70	$80

Central Bank, Macro-Advisory

Forecasts: pessimistic case

- Sanctions remain intact, but no worse, until after the US presidential election in November 2016.
- That forecast assumes that the oil price will decline further and remain low for longer; it assumes that current US sanctions remain in place and EU sanctions are renewed; it assumes a continuing weak policy response from the government/state agencies and poor crisis management

Russia - Macro Outlook

		Base Case Assumptions				Pessimistic Assumptions		
	2013	2014E	2015E	2016E	2017E	2015E	2016E	2017E
Growth, real % YoY	1.3%	0.5%	-4.0%	0.0%	1.5%	-7.5%	-2.0%	0.0%
CPI - year-end, % YoY	6.5%	11.4%	12.0%	8.0%	6.0%	13.5%	9.0%	7.5%
Gross fixed investment, real % Yo	-0.3%	-3.5%	-10.0%	-2.0%	2.5%	-12.5%	-5.0%	2.5%
Central Bank Key Rate, %					17.0%	13.4%	9.5%	8.0%
Retail sales, % YoY	3.9%	2.0%	-6.0%	0.0%	2.0%	-9.0%	-2.0%	2.0%
Unemployment, % EOP	5.6%	5.3%	6.5%	6.0%	5.5%	7.5%	6.8%	5.8%
Budget, balance % of GDP	-0.5%	-0.5%	-2.0%	-1.5%	-1.0%	-3.0%	-2.0%	-2.0%
Current account, % GDP	1.7%	3.0%	2.5%	1.8%	2.0%	2.0%	1.5%	1.5%
RUB/US$, year-end	32.9	63.1	70.0	60.0	50.0	80.0	70.0	60.0
RUB/EUR, year-end	45.3	72.0	75.0	66.0	55.0	88.0	77.0	66.0
Urals, US$ p/bbl, average	$108.0	$100	$50	$70	$80	$45	$55	$65

Source: State Stats Agency, Central Bank, Macro-Advisory estimates

Scenario probabilities

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- Discounting the probability of a **worst case** (*a more extensive war, tightening of the financial sector and economic sanctions and some exclusion of foreign companies*) or a **best case** (a *peace deal with Kiev, sanctions lifted early and oil rallies*). Also discounting an **optimistic scenario**.
- The greater likelihood is either of our **base case** or **pessimistic case**. The key difference between the two is outside of Russia's control, i.e. sanctions and oil, but crisis management and policy changes will also make an impact.
- However, in both cases we assume that the current evident divide between the aggressive politics and the efforts to limit damage to the economy and the longer-term investment case, will remain.

Probability for Growth & Investment Scenarios

Scenarios	Probability %
Best	5%
Optimistic	10%
Base Case	45%
Pesimistic	35%
Worst	5%

Source Macro Advisory Ltd

Worst & best sectors - examples

- **Retail sales** are expected to be hit hard this year, as the consumer can't afford to spend as much as previously and sentiment is low. Consumers are expected to be a lot more conservative in 2015. But the better managed and structured retailers will likely gain significant market share.
- **Discretionary** spending/big ticket items will be worst hit. **Internet services** & **IT** are better placed.
- **Transport**, **cargo** and **logistics** will face a slowdown with overall economic activity.
- High interest rates and a more difficult banking market will mean that the **housing market** and **related industries** will decline.
- Industries which need to **import components** or materials will suffer a further margin squeeze due to the weak ruble and low pricing power in the markets.
- **Banks** face a major funding problem and a big hike in NPLs. Expect dozens of lower "top-100" banks to face problems if not outright failure (to be rescued or absorbed by the state banks).
- State **regulated industries** such as **utilities** and others (**fuel suppliers**) which are part of the inflation calculation
- **Capex investment** spending will again fall sharply. Suppliers & services will also take that hit.
- Industries generally in the "**import substitution**" category will fare better than in 2014.
- Industries associated with the still high-spending **defense equipment** sector.
- **Extractive industries** will be mostly influenced by global rather than domestic events & trends

Oil & Sanctions

- If Urals rallies back to US$60 p/bbl but sanctions remain?
  - *The ruble may rally towards 60 p/US$ over the medium term, but the economic impact of the sanctions on investment, etc, will lead to a weaker ruble in the autumn. Year-end RUB65/US$*
  - *Investment flows remain negligible and Russia continues to deplete reserves*
  - *Still no default or budget/bank crisis but definitely in a longer stagnation*
- If Urals rallies to US$80 p/bbl but sanctions remain?
  - *Ruble–US$ can rally to the 55-60 band medium term, but stagnation outlook and low investment will push the currency lower by year-end to approx. RUB55/US$*
  - *Inflation will ease sooner and rates will clearly come down by mid-2Q15*
  - *Budget in good shape and no threat of defaults.*
  - *Continuing low growth, e.g. 1 to 2% p.a.*
- The main impact of sanctions tightening or remaining into 2016?
  - *Sanctions keep a sense of crisis in the country*
  - *The are a distraction preventing any real focus on economic management (other than crisis management)*
  - *Reforms are of secondary importance*
  - *A sanctions regime can always get worse, i.e. added to, and further damage the economy*
  - *The risk premium for investors remains very high because of the uncertainty factor*
  - *Inward investment and Russia investment stay negligible*
  - *Existing foreign company investors are restrained by HQ … again due to the uncertainty factor.*

  - ***Caveat:*** ***If sanctions tighten materially, e.g. an exclusion from Swift, then all forecasts will have to change materially.***

Oil & Sanctions

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- If Urals slips towards US$40 p/bbl and sanctions are not renewed by the EU?
  - *The ruble will continue to slide with the oil price rather than rally with the improved political news. At US$40 p/bbl Urals the RUB-US$ rate would test the previous intra-day high of 80.*
  - *Inflation would push higher than the 15% (approx) peak expected and that would keep interest rates high for longer*
  - *Some of the bigger Russian companies will be able to access debt, roll-over and raise new debt … but it will be limited*
  - *A second year of GDP contraction in 2016 – more uncertainty about political stability*
  - *Investors would likely stay away from Russia until there is clearer evidence of a firm commitment to real reforms*
- If the EU does not renew sanctions but the US keeps its sanctions in place?
  - *If the US keeps its sanctions against financial companies in place, most Russian companies will still find it hard to access external debt/credit. EU banks will be wary of US regulators*.
- If oil rallies back to US$80 p/bbl and financial market sanctions start to ease in the autumn?
  - *Essentially this is our base case– see macro forecasts on slides 5 & 6*
  - *In this instance Russia's indicators may return to a "2013" result rather than better*
  - *Financial markets would ease up and budget/banking pressures would reduce considerably*
  - *Ruble-US$ rate would likely remain in the 50-55 range until investors become convinced of real change/reforms*
- Can Russia get back to the targeted 4-5% annualized growth?
  - *Only with the new growth model identified in late 2013, i.e. based on higher and sustainable investment spending*
  - *That will only happen if there is a greater commitment to reforms and to improve the investment and business climate for both Russians and foreign investors*
  - *There is real diversification in the economy and the state starts to reduce its role.*

When will interest rates be cut?

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- The Central Bank raised its Key Benchmark rate four times in 2014. The Key Rate was 5.5% on 1 January 2014 and 17% 31 December 2014. The cut in Russia's sovereign rating will make it very difficult for the CBR to cut its interest rate before the April 30th or June 15th policy meetings
- The MosPrime 3m rate was 21.6% (23 Jan) and the O/N rate was at 17.7%. Now they are back to 17.5% and 15% respectively after the recent Key Rate cut (to 15%)
- The higher rate is supported by the Central Bank because:
  - It will slow consumption and help moderate inflation
  - It can provide some stability for the ruble (all else being equal with oil)
  - It may slow "personal" capital flight as domestic deposit rates are near 20%
  - High deposit rates may slow the outflow of deposits from the banks or help attract new deposits
- The Economy Ministry has argued for a lower rate because of the damage to economic activity caused by the high rate. The Ministry also argued that the special "rise" on 16 December (from 10.5% to 17%) was no longer necessary as the ruble has stabilized.
- The Central Bank's next three Policy Meetings are due to be held on 13 March, 30 April and June 15th.
- Most likely we will not see another rate cut until the Central Bank is convinced that the inflation peak has passed.

Will the ruble rise or fall?

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- The key driver for the ruble on the downside is the oil price. Both the price of Urals crude and the RUB/US$ rate fell just under 50% from 1 September to end-year 2014. But, since Jan 1 '15 the oil price is up 9%* while the ruble-US$ rate is off 5%* (The RTS Index is up 12.5% and MICEX is 19% better)
- The weak ruble (mostly) protects the federal budget from the falling dollar export tax earnings.
- The weak ruble provides an indirect stimulus for domestic manufacturing and service suppliers.
- The weak ruble allows the government to continue raising pensions and public sector worker salaries in line with inflation – and protects the president's core support base.
- Over the next six months the ruble should continue to move closely with oil – if Urals falls to US$40 (the Jan 2009 low point), then the RUB/US$ rate may trade in the 75-80 range. If Urals rallies to US$60 the RUB/US$ range may reach 60, if sanctions remain.

* As at close February 10th

May oil rally or fall further?

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- The headline issues are:
  - Demand growth has slowed due to sluggish economic performance
  - Whatever demand growth is coming through is being met with the fast rising US shale oil Neither OPEC nor any of the non-OPEC producers are willing to cut supply anytime soon
  - US shale output is becoming more efficient (technology advances) so breakeven price is falling
  - The strengthening US dollar is, historically, negative for the oil price
- For OPEC it is a matter of market share and a battle to force better coordination between OPEC and non-OPEC to achieve a more stable price.

World Oil Supply & Demand - Market Share changes past 15 years

Supply*	1989	1999	2008	2013	2014E	2015E
Total OECD Supply	**30.3%**	**28.6%**	**21.7%**	**23.0%**	**24.2%**	**25.0%**
Total non-OPEC supply	**24.2%**	**60.6%**	**36.6%**	**36.7%**	**36.7%**	**36.6%**
OPEC Crude	**41.8%**	**35.6%**	**36.5%**	**33.4%**	**32.0%**	**31.4%**
of which:						
U.S.		*10.8%*	*8.9%*	*11.3%*	*12.7%*	*13.5%*
*Russia**		*10.0%*	*11.6%*	*11.9%*	*11.8%*	*11.6%*
Saudi Arabia		*10.1%*	*10.3%*	*10.3%*	*10.4%*	
Total World Supply - mln bbl/d	**52.4**	**74.7**	**86.8**	**91.4**	**92.4**	**93.5**
Demand						
OECD Demand	**71.8%**	**63.7%**	**55.0%**	**50.3%**	**49.4%**	**48.7%**
Total Non-OECD Demand		**36.3%**	**45.0%**	**49.7%**	**50.6%**	**51.3%**
of which;						
China		*6.0%*	*8.9%*	*11.1%*	*11.1%*	*11.3%*
Other Asia		*9.4%*	*11.2%*	*12.7%*	*13.2%*	*13.4%*
Total World Average Daily Demand - mln bbl/d	**52.4**	**74.7**	**86.8**	**91.4**	**92.4**	**93.5**

Source: International Energy Agency, Macro-Advisory estimates - November 2014 Oil Market Report
** Russia total includes process gains and liquids*

There are differences with 2009

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- There are a number of important differences with 2008-09 oil price crash:
  - The oil price crashed due to the build-up of supply and sluggish demand … in 2009, the price crashed because of the sharp global downturn. The price rallied in 2009 as global growth picked up. That is not the case this time. There will have to be a supply side adjustment to rally the price
  - The US dollar entered a long period of weakness with the Fed's QE programme (April 2009) and that also helped rally oil. Today the US dollar is rallying and is expected to continue that move higher.
  - OPEC producer country budgets all need a much higher oil price average to breakeven today. Some have sizeable reserves … most do not and are already in trouble.
  - Shale production – technology is advancing rapidly which will lower the breakeven cost for many producers.
  - The potential for disruption of output remains high in , e.g. Libya (civil war), Nigeria (Boko Haram), Venezuela (economics).
- However, the Saudi Arabia led moderates (+ UAE and Kuwait) can ride low oil for longer and still achieve their target of US$100 p/bbl average for the decade.

US$100 p/bbl Target - Bad case

Calendar year	Average Brent, US$ p/bbl
2011A	$111
2012A	$112
2013A	$110
2014A	$101
2015E	$40
2016E	$60
2017E	$80
2018E	$100
2019E	$110
2020E	$110
Ten year average price	$94

Source: Bloomberg, Macro-Advisory estimates

OPEC Breakeven Oil Price**

	Budget Price Required	mln bbl p/day
Libya	$184	0.9
Iran	$131	2.7
Algeria	$131	1.1
Angola	$131	1.7
Nigeria	$123	1.8
Venezuela	$118	2.8
Saudi Arabia	$106	9.6
Iraq	$101	2.9
Ecuador	$80	0.5
UAE	$77	2.8
Qatar	$60	0.7
Kuwait	$54	2.9

Source: I.M.F. or Internal government reports / WSJ

Does the credit rating matter?

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- Russia's sovereign credit rating is now "junk" with S&P and the other agencies may follow in March or April. That will depend on where oil is trading, on the sanctions outlook and the government's response to the crisis.

- Currently, the rating is mostly academic, as Russian companies and the MinFin cannot access any foreign debt sources. However, it adds pressure on the ruble and will raise external debt payments in 2015.

- But, to cite the adage "it is easier to lose than to gain" the problem for Russia will be that the "junk" rating may last longer than the oil price recovery and longer than sanctions. That would have the effect of:

  - Excluding Russia and Russian companies from accessing debt from most of the world's biggest investment funds, as they have a minimum investment grade requirement
  - The cost of accessing debt from other investors would therefore be higher than with an investment grade rating
  - Recovery in the economy would be slower
  - Recovery in the banking sector would be slower as banks would have a tougher credit rating criteria than investment funds
  - Confidence in Russia would be harder to rebuild and that would hurt inward investment flows

- A loss of investment grade also impacts budget (and corporate issuer) spending as debt service costs will be high in many instances and some existing debt will be called in early.

- Recovery in the investment banking sector will be a lot slower.

Is there any default risk?

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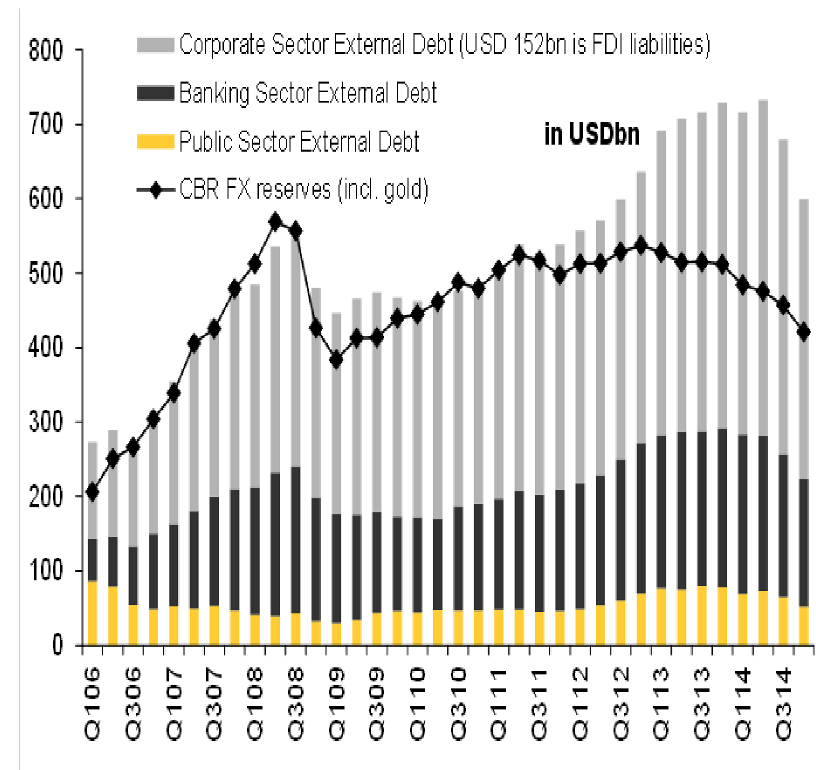
- There is no credible threat of a Russian sovereign default risk, or amongst the state enterprises or amongst the countries biggest banks and industrial companies.
- In total Russian entities need to pay approx $110 bln to cover foreign debt in 2015. But excluding inter-company payments and ruble debt the total falls to less than $60 bln
- Russia's total foreign debt fell by US$130 bln in 2014 to end the year at US$599 bln, or approx 30% of GDP.
- Taking out the US$105 bln denominated in rubles and the US$131 bln of inter-company loans, the total real external FX debt is US$363 bln.
- The total value of Central Bank reserves is US$376 bln, a drop of US$124 bln in 2014. Gold and other less liquid holdings is US$58 bln so the liquid cash position is US$318 bln.
- The Reserve Fund has US$90 bln (approx) and the Welfare Fund has US$85 bln, of which US$30 bln is committed. The Funds will be available for, e.g. bank capital funding.



The money flows

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- Russia runs a Current Account surplus, which was US$56.7 bln in 2014, up from US$34 bln in 2013. That was mostly due to the collapse in imports.
- Russia's trade surplus totaled US$186 bln in 2014, up slightly from a surplus of US$182 bln in 2013.
- It means that Russia is replenishing its inflow of foreign currency and boosting the value of CBR reserves.
- The weak ruble + the sanctions against some food imports also help push imports lower and boosts the Current Account surplus.
- Capital outflow totaled US$152 bln in 2014. But a significant amount of this total is due to the repayment of foreign debt (reduced US$130 bln) while the portion of "cash flight" is relatively small.
- The big issue is the accumulation of capital flight since 2008 and the fact that Russian people and companies are not investing in the country.

Central Bank Foreign Exchange Reserves, US$ bln

Date	Total, US$ bln	% in FX	% in Gold
01/02/2015	$376	89.0%	12.0%
01/01/2015	$386	89.0%	12.0%
01/12/2014	$418	89.0%	11.0%
01/10/2014	$454	89.9%	10.1%
01/09/2014	$465	90.1%	9.9%
02/09/2013	$510	91.1%	8.9%
03/09/2012	$515	90.3%	9.7%
04/09/2011	$545	91.1%	8.9%
05/09/2010	$476	93.9%	6.1%
06/09/2009	$410	95.7%	4.3%
07/09/2008	$582	97.7%	2.3%

Source: Central Bank of Russia

Note: Peak was US$596.6 bln on 1 August 2008

Capital Outflow from Russia 2008-15E

Year	Total Outflow, US$ bln
2008	-$133
2009	-$57
2010	-$34
2011	-$81
2012	-$57
2013	-$63
2014	-$152
2015E	-$120

Source: Central Bank

How likely is a banking crisis?

- A banking crisis is avoidable … but may still happen if the Central Bank/MinFin is slow to react to a worsening of the crisis.
- The Rub 1 trillion OFZ provision to the major banks and the appointment of Dmitry Tulin to head the Monetary Policy Dept are both considered to be very positive for the sector.
- The bank's core problems are:
  - A sharp drop in deposits in 2014 as,
    - people and companies switched from rubles to foreign currencies
    - companies were unable to access any foreign credits and drained local resources
  - NPLs amongst individuals and industrial clients are expected to rise sharply as the economy weakens
  - Households were already struggling to service existing debt before the December rate spike
  - Many Russian banks are exposed to Ukraine debt ... they are the biggest holders
- Russia now as 872 licensed banks. That is down from over 1,150 in January 2009.
- Only 418 banks currently satisfy the Central Bank's minimum capital requirement; the others are at risk of losing their license.
- The government has a long standing strategy to cut the number of banks to "less than 300".
- State banks are expected to acquire many of the medium-sized banks which get into difficulties.

May we see a political crisis?

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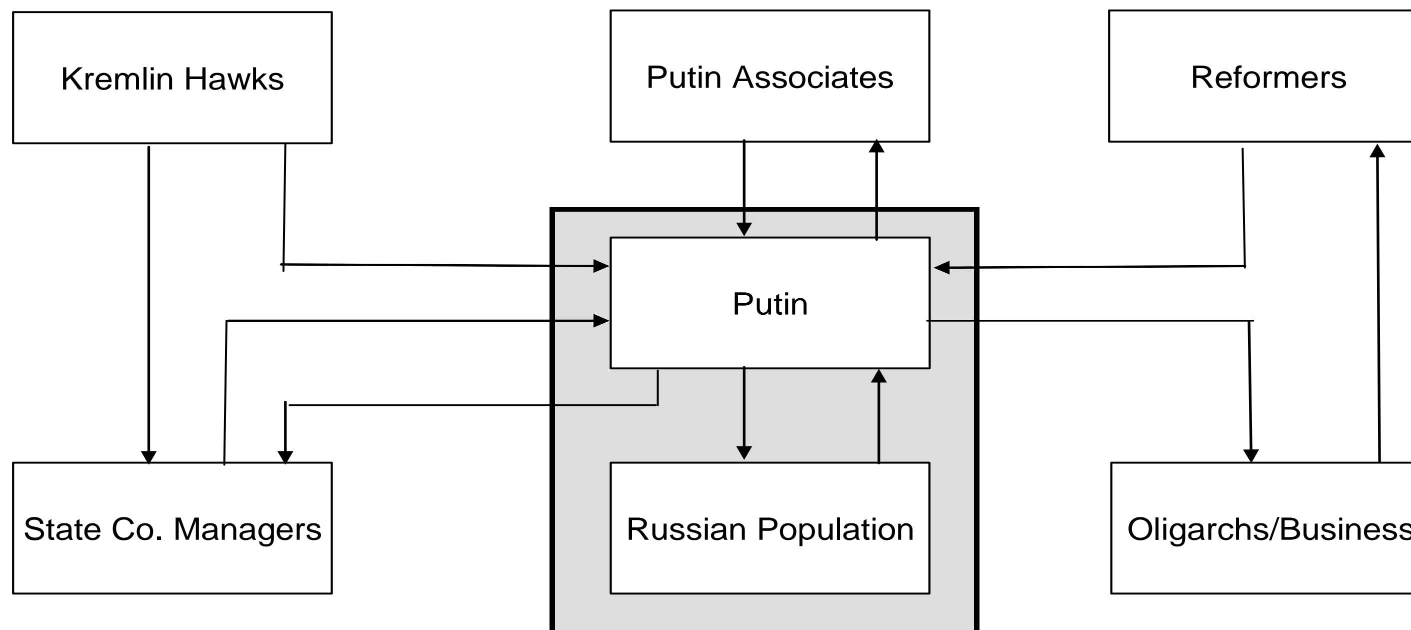
- Public support for President Putin remains strong. That is the key relationship – the only one that matters.
- But recent opinion polls show a decline in public support for the country taking responsibility for Donbass and a rising level of concern about inflation and job security.
- Reformers are very vocal in the media – possibly trying to shake complacency and get support for actions?
- Oligarchs and business leaders appear to have little influence or access to the president



Source: Macro-Advisory Ltd estimate

Hence, the economy matters

- It is assumed that Putin wants to be re-elected in 2018 and will remain until May 2024.
- No major change is expected in domestic politics – but only so long as the Kremlin delivers on domestic economic and social expectations. This is critical to maintaining the current political order and for Putin to achieve his long-held objectives.
- There is, therefore, a very clear divide between the (expected) belligerent geo-politics and the Kremlin's need to remain open for foreign business/expertise and investment.
- The country cannot remain in the current slump indefinitely without the risk of a public and political reaction. Putin is well aware of this and it does matter to him.
- Putin never sends in the riot police when ordinary people in sufficient numbers protest. Examples include the 2005 social welfare breakdown, the 2009 protests in Tolyatti and the December 2011 protests in Moscow (after the initial dismissal).
- The need for continued involvement in helping domestic industries develop more efficiently was clearly seen in the effort to buy Opel (2009) and in the terms of the privatization program. This year the Kremlin blocked efforts to force out Visa/MasterCard, McDonalds, Ikea etc., and made it clear that it would only approve actions which helped rather than hurt the economy. This was also the clear message at Putin's Federal Assembly address in early December.

Import substitution – what impact?

- Import substitution, or self-reliance, has emerged in recent months as the most important policy priority for the government. This is a policy which President Putin has been pushing aggressively since 2010 (the agriculture crisis), but with little administrative success. Now he has another opportunity to make this almost a patriotic crusade.

- The emphasis will be on products which the government believes are: a) of strategic importance to the economy, and b) which may actually be manufactured inside the country.

- But, it is important to keep in mind that even as this policy has now emerged as the number one priority, it will be 3-5 years before Russia is self-sufficient in some areas. Bureaucracy and confidence amongst potential investors will be slow to change.

- We expect to hear some of the administrative initiatives to help boost this strategy at next year's Economic Forum in St. Petersburg (mid-June).

- Industries included are: agriculture, food, pharmaceuticals, auto parts, machinery parts, defence industry equipment, etc.

China/Asia pivot – a game changer?

- The move to increase trade with and investment China, Asian and non-West countries is certainly real. This will remain an important part of the government's recovery strategy for many years. Cross-border trade with many Asian states will grow over the next 5-10 years.

- But the Kremlin and other officials have consistently made it clear that this is not an "either or" situation with the West, but part of a long overdue diversification strategy. There is zero intention to replace Western companies with competitors from Asia. Putin was again clear about this in his recent speech.

- Chinese investors have also been equally clear that they are only interested in sectors which will help their economy, e.g. energy and infrastructure primarily and raw materials extraction in general.

- The government is most interested in processing more raw materials inside Russia to add-value in some form, and then to export the finished or semi-finished products to China and other Asian countries.

- Chinese/Asian/non-West investors will get access to more raw materials and materials processing inside Russia. But also under the same terms as for Western companies, i.e. as JV partners rather than exclusive owners.

Investment opportunities

- Despite the "pivot-East", it has long been recognised that Russia needs the involvement of (mostly) Western expertise in specific industries, eg, in the auto sector.
- Import substitution is expected to be the main industrial policy for several years.
- PPP schemes in infrastructure may finally get a boost.
- Private Equity opportunities may be easier (2H15) than direct investment from high profile foreign companies for several years.
- Specifically:
- *Agriculture and domestic food production*
- *Technology*
- *Manufacturing sector, services and parts*
- *Consumer sectors generally – the slowdown in spending is still most likely a one-to-two year blip … the middle class is still expanding and lifestyles are migrating towards Western standards*
- *Healthcare*
- *Leisure sectors – especially if Russians are more inclined to stay at home for vacation*
- *General infrastructure – focusing medium-term on the 2018 World Cup*
- *Strategic industries, eg, aviation and shipbuilding – probably in a services or supply role*

What are the key risks?

- Putin is forced out of the Kremlin, by insiders, or by illness/accident. Over the medium term his more likely successor would be somebody from within the ruling elite and that would mean a greater focus on geo-politics, on nationalism and much less on economic development.

- If the EU/US were to intensify efforts to tighten the noose around Russia with a view to force regime change, e.g. the Republicans have threatened a 10-year legislative sanctions program. That could provoke a political reaction and threaten the position of US companies operating in Russia or those with federal/regional contracts. The EU is most unlikely to follow such a route.

- Another “Black-Swan” event in Ukraine which forces an EU response. The next step is a ban on trade in more products, e.g. parts for the manufacturing sector, or a ban from the SWIFT banking system. That would crash the economy harder and lead to a political response.

- Oil price crashes. Unlikely to last very long as OPEC countries are now hurting as much as Russia (Venezuela is close to default) and new shale in the US is uneconomic. But the Kremlin's response is more likely to be to try and accelerate reforms, more political conciliation with the EU and an effort to complete more deals with Asia.

- Oil price rallies back to US$110 p/bbl. Good news for the ruble and the economy generally – likely very bad news for efforts to focus on reforms or make real changes.

Major Risks – longer term

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- The **tax base** is expected to start changing, i.e. higher taxes, after the March 2018 election. The Finance Ministry wants to push higher revenues and diversify away from energy.
- Russia's **active workforce is shrinking** and may fall by up to 10% over the next 8 years. Russia needs to boost immigration or to re-train and relocate workers from existing non-productive, mostly state jobs.
- The **pensions liability is growing**. The government is currently grabbing future contributions to fund the current budget and that will make the problem greater and more expensive to solve.
- **Regional budget deficits** are growing fast – Putin's re-election promises (2012) were mostly pushed onto regional budgets.
- The **state's role in the economy** is again growing as a result of the crisis. This will be harder to roll-back afterwards. The state is inefficient.
- Privatizations may be indefinitely delayed.

Contacts

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